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Veröffentlichungsversion / Published Version
Zeitschriftenartikel / journal article

**Empfohlene Zitierung / Suggested Citation:**
Huxham, G. T. (2017). Is a Fixed PEG a Fact of Life in the GCC? *IndraStra Global*, 8, 1-4. https://nbn-resolving.org/urn:nbn:de:0168-ssoar-53429-5

# Is a Fixed PEG a Fact of Life in the GCC?

indrastra.com/2017/08/Is-fixed-PEG-Fact-of-Life-in-GCC-003-08-2017-0016.html

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Authorities have been managing the quoted interest rate since the 2008/2009 financial crisis. And for many, positive interest rates have not created much of a concern.

Prior to 2008, a different world existed with positive interest rates. One characteristic of the interest rate - earned or paid - is the degree to which it may differ when quoted by a fiscal authority in a different region or country. For example, assuming all other factors are equal, if the interest rate earned on euros in France is three percent, and in Italy seven percent, an economist might conclude that the cost of living must be higher in Italy and the rate of inflation also higher, since interest rates quoted take into account the real rate of return plus a premium that reflects local inflation. A businessman, on the other hand, might assume that since higher rates in Italy are associated with higher risks, France would be a safer place to invest capital and conduct business.

Such conclusions become more complicated if one country fixes the rate of conversion of its currency to another country. This is known as *"pegging the currency".*

This article will comment on the pressures that have arisen from certain members of the Gulf Cooperation Council (GCC) having pegged their currencies to the US dollar. It is in no way a commentary on actual policies adopted by the central banks of the countries, and, to the extent that these central banks are not independent of their governments, the policies of the government of the day.

### The Dismal Science and War

Significant research has been conducted and continues to be conducted, to identify appropriate responses to issues such as the causes and treatment of recessions; the true implications of trade between countries; the appropriate role of taxation in an economy; and the anticipation of crises based on current trends.

Economics, or the *"dismal science"*, can also be informative when significant imbalances occur. The two following examples of wealth transfer illustrate that economic stress can result in political adjustments within a country and can even prompt war with another.

A significant trade adjustment took place when China requested payment for its tea from British and European silver traders. That policy resulted in the considerable transfer of silver from Europe to China – until the British, in turn, began to sell opium (accessed from Afghanistan via Imperial India) to China and demanded payment in kind. Chinese consumers of opium soon outnumbered tea drinkers, and the flow of silver reversed. When the Chinese emperor attempted to eliminate opium consumption and eject the traders, the Opium Wars ensued, which led to the ultimate disintegration of China and to the enrichment of London via the tea trade (creating issues of 'copyright infringement' as tea clippings were 'stolen' and transferred to Ceylon) as well as immoral gains from the sale of opium.

A more recent example is the significant trade adjustment that took place when the price of oil soared from an abysmal USD 19.92 in August 1998 (symptomatic of the doldrums caused by the 1998 Asian economic implosion) to a breath-taking USD 156.62 in June 2008. That policy resulted in a significant transfer of resources from the U.S. and Europe to the Middle East, yet only an ideological war ensued.

NASA was funded in response to the Cold War – and the determination of an administration that wanted to win a propaganda war, despite the related cost, against the Soviet Union. This transfer of wealth led to engineering advancements and kick-started the fracking revolution in the U.S. that has driven oil prices to the current USD mid-40s per barrel. Was this a war? Yes, because economics doesn't discriminate between nations. It was a contest for resources conducted on the most basic level, involving a seller and a buyer of finite resources. If your strategy is superior, you win - and possibly you win all. Presently the frackers hold a winning hand.

Albeit opium or fracking technology, it pays to hold a competitive advantage over your opponent – especially if you take the initiative in determining events.

## Exposures Caused by Utilizing a Pegged Currency

Before the 2008 crisis, a group of eminent economists was intent on understanding the implications of pegged exchange rates - specifically with reference to the European Monetary System - following attacks on Exchange Rate Mechanism, or ERM, members.

Their research presented an empirical analysis of speculative attacks – also defined as crises or large movements in exchange rates, interest rates, and international reserves – with the stated goal of attempting to identify the behavior of macroeconomic variables around the time of speculative attacks.

Economists were asking questions like, *"Are there differences in the behavior of key macroeconomic variables prior to speculative attacks on pegged exchange rates as compared to other periods? Does the behavior of these key variables change in the aftermath of speculative attacks? Do answers to these questions differ in the different times and places in which exchange rates are pegged? Do they differ for ERM – and non-ERM currencies, in particular?"*

Their research highlighted differences between the ERM and non-ERM currencies. For the non-ERM sample, they wrote, *"We find significant differences in the behavior of budget deficits, inflation rates, rates of credit growth, and trade balances when comparing periods preceding speculative attacks and control-group observations."* [Emphasis added].

Countries which have pegged their currency (outside a region where a central bank asserts some influence, e.g. the European Central Bank) experience volatility in the currency during and immediately after a crisis - as demonstrated in an era where there were arguably fewer globalization influences and connections between financial markets on a regional basis.

The authors further noted, *"A final important finding is that the behavior of macroeconomic variables differs significantly from the time of speculative attacks on the one hand and realignments and changes in exchange rate regimes on the other. ERM countries undergoing realignments have significantly higher inflation rates, interest rates, rates of money and credit growth and budget deficits, and their trade balances are significantly weaker. None of these statements is true about the events associated with realignments of non-ERM currencies or with the collapse of the Bretton Woods, Smithsonian, or Narrow Margin regimes of pegged exchange rates. Our investigation has obvious relevance to current policy concerns. 1992 and 1993 saw a series of speculative attacks on European currencies that drove the Italian lira and the British pound out of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) and challenged the viability of the Maastricht blueprint for European Monetary Unification (EMU). There remains considerable dispute over why these crises occurred".*

The authors articulated two competing views as to why these crises had occurred. One view asserted that lax monetary and fiscal policies, accompanied by excessive wage and price inflation which had eroded competitiveness, combined with a capital account deficit, had contributed to an *'attack on the currency'*. The other maintained that the evidence of lax policies was not compelling and that it was the attacks themselves that had caused the fiscal authorities to raise interest rates which then created macroeconomic imbalances, rather than the other way around.

Yet the authors' concluding remark appears prescient post-1994: *"In turbulent periods, in contrast, observers display deep skepticism about whether policymakers will be able to resist market pressures regardless of the policies they are currently pursuing."* [Emphasis added]

Research conducted in 1998 further examined the question whether the pegging of currencies was a good strategy for emerging market countries.

In summation of his research, Frederick Mishkin asserted: *"First there are the usual criticisms of exchange-rate pegging, that it entails the loss of an independent monetary policy, exposes the country to the transmission of shocks from the anchor country, increases the likelihood of speculative attacks and potentially weakens the accountability of policymakers to pursue anti-inflationary policies."*

*"However,"* he continued, *"most damaging to the case for exchange-rate pegging in emerging market countries is that it can increase financial fragility and make the potential for financial crises more likely. Because of the devastating effects on the economy that financial crises can bring, an exchange-rate peg is a very dangerous strategy for controlling inflation in emerging market countries. Instead, this paper suggests that a strategy with a greater likelihood of success involves the granting of independence to the central bank and inflation targeting".* [Emphasis added].

Regardless, economists agree that to the extent to which a country is an *"open-economy"*, with a currency tied to a foreign currency, during times when interest rates are low or benign, things are relatively easy to manage from a fiscal and monetary perspective.

But an increase in the value of the reference currency (a growth in the dollar) causes unintended cost inflation in the pegged country. For example, Gulf News reported, *"Dubai and Abu Dhabi remain firmly entrenched among the most expensive cities in the world for expats, with the strong dollar being the primary factor in pushing them up the rankings. The former was placed 21st and Abu Dhabi 25th, based on the influential "Cost of Living Survey" brought out by the consultancy Mercer."* It was published on June 22, 2016, when the U.S. dollar was on an appreciation tear.

Over time, if the imported inflation and resultant pressure on interest rates become continuous and significant because of the strength of the reference currency relative to other currencies, countries are forced to consider re-setting the peg.

### So What?

If you live in a GCC country, a good dinner party topic is the merits and demerits of a change in a peg.

A positive impact is that the real local cost of labor decreases to the extent that labor contracts are specified in the local currency; ditto for rental of property and debt contracts, while the real value of exports increases.

The negative impact is that imports become even more expensive and foreign investors may be peeved by the loss in value attributable to payments received against a debt schedule denominated in local currency. And real wages earned by expats are reduced, which may lead to a brain-drain and a capital flight.

Those are the measurable and tangible economic costs. For an economy such as Saudi Arabia's, for example, the relative increase in the value of exports might well offset any increases in importation costs - especially to the extent that food security has been managed and secured internally.

But the real issue is one of honor. Would a managed devaluation of the peg be perceived as a loss of honor? That depends. Was the reputation of the Bank of England any better for adopting a principled position to maintain its "word" when George Soros took advantage of the obvious market perception that an arbitrage opportunity existed? How much is your reputation worth if it unnecessarily costs you your shirt? To some, that question is not even worth considering. But the message economics research poses is a simple one: *"Ignore re-valuation at your own risk."*

Abandoning the currency peg (devaluing the currency), walking away from foreign debt (restructuring at deep discounts) and resetting disbursements to citizens - although definitely a possible course of action by any country in the GCC – would not be palatable to most central banks. Economically, it may have worked in the past for countries like Brazil, but culturally it is not a path that would be welcome in the MENA region.

But times change and so do customs.

### All's Fair in Love and War

Zhou Enlai's declaration that all diplomacy is a continuation of war by other means complements Clausewitz's maxim that war is the continuation of politics by other means. This concept is worth examining. As stated earlier, economics can be likened to war, with its strategies of maximizing resources by the active participants. This article has shown that a consequence of turbulence is *"attacks"* on a pegged currency.

In order to wage war - or diplomacy - or politics, to seek advantage over another country in the pursuit of resources, how does a country win, if both nations have currencies pegged to a common foreign currency?

It's much easier if the other country is already under attack, experiencing turmoil, with state enterprises losing the foreign exchange. The aggressor can articulate a strategy to foreign investors so that it is understood that it is doing this by choice, not by necessity, and then conduct a managed devaluation of its own currency.

The outcome is increased competition for the aggressor's exports – and the satisfaction of watching the other country waste precious forex reserves trying to support its own currency relative to the peg, while becoming much more expensive in terms of local costs.

Should the country under attack respond by lowering its costs – research has shown that currencies under attack slide faster and harder than central banks can manage (or predict) under siege. If you do it wrong, Zimbabwe is your lot. And over time, economic disruption on a significant scale always brings regime change. Ask the Weimar Republic about that.

But what emerges afterward? That's a question for the sociologists.
***Gulf State Analytics*** *(**@GulfStateAnalyt**) originally published this article on August 9, 2017*

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